RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year – $150 Annually
Registered with the Securities and Exchange Commission

July 12, 1978 | LETTER 734 | June 30, DJIA 818.95; PTI 819; A-D Ratio –19.54
July 7, DJIA 812.46; PTI 806; A-D Ratio –19.97

PROJECTING: After milling about and sinking a bit further, the market bases, then pushes higher. By August the June 6 highs of 866.51 for Industrials, 231.35 for Transports, are bettered. Volume expands dramatically, and Wall Street screams "Bull signal, bull market." The worst that can be seen ahead, the higher interest rates, the slowing economy, the incompetence of President Carter, have obviously all been discounted. The secondary stocks start up again, this time joined by the Dow stocks. Forbes magazine's mid-September cover is ablaze with a picture of a giant, fire-breathing bull. That's scenario number 1.

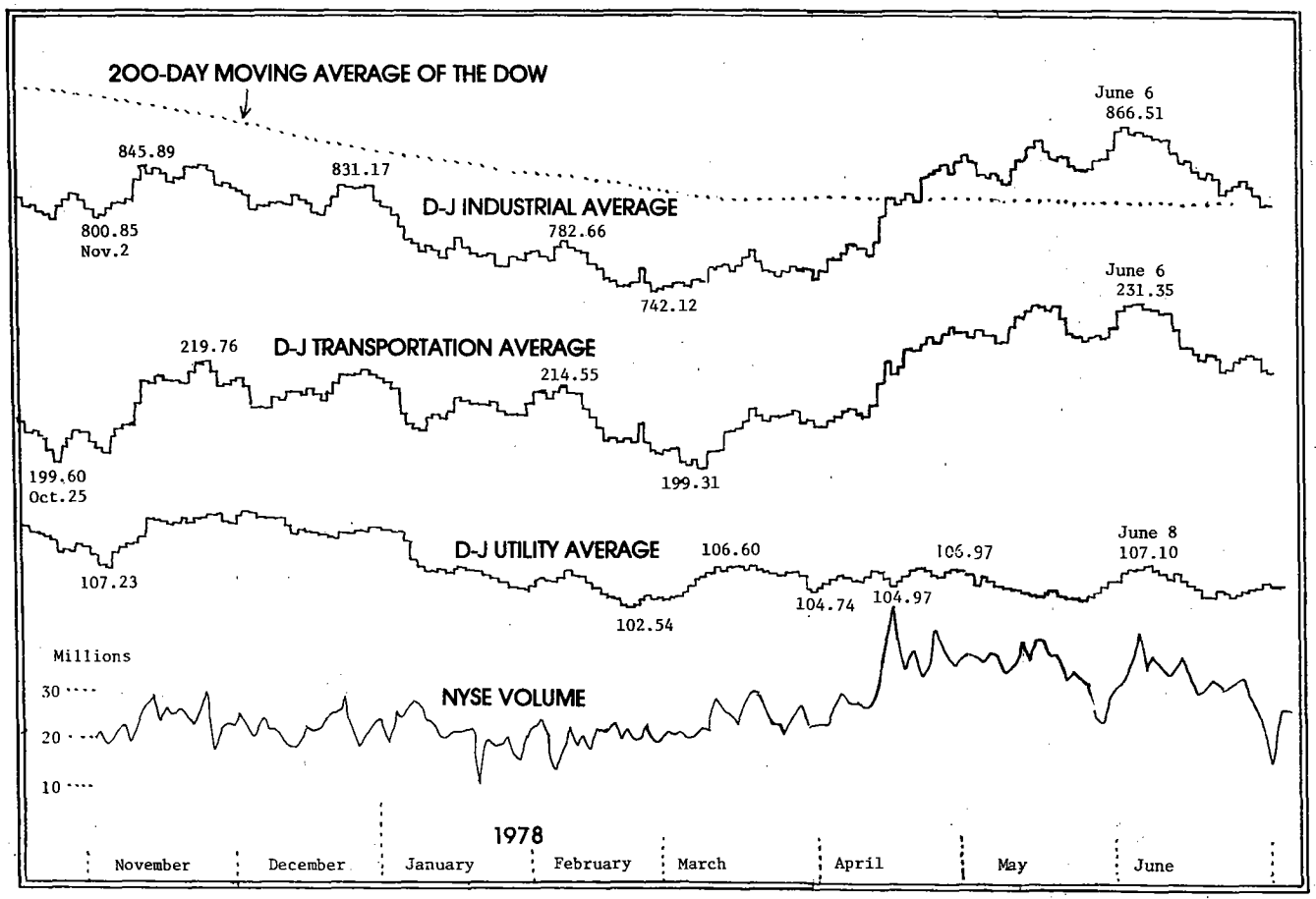
Here's scenario number 2. The Averages mill about and sink lower, but selling pressure doesn't really expand. The bears get discouraged; the bulls fail to become enthusiastic. Interest rates hold at high levels but could be peaking. Volume on the NYSE simmers down to an average 17 million shares a day. The dollar seems to stabilize as does US business. A long tedious stag-flation period follows which takes the market trendlessly into 1979. The bull camp and the bear camp become more vocal, more insistent, but nothing of any import occurs. The public grows increasingly disgusted, and the only thing certain is that brokerage house equities are a sale.

Next, scenario number 3. The bulls have underestimated the trend and ferocity of the money picture. With $45 billion of new financing by Government agencies, with $35 billion of new financing by the Treasury, with a rush by the banks and the S&L's for new money, the second half of 1978 becomes a monetary nightmare. The prime rate marches over the 10% level, interest on brokerage margin accounts climbs over the 13% level, and the long end of the bond market dissolves into shambles. In this atmosphere the stock market has nowhere to go but down.

By late July, in the face of a feeble corrective rally, the 1978 buyers realize that they have been "locked in" to one of the costliest bull traps in history. Confronted by falling stock and bond prices, foreigners pull their money out of the US en masse, and interest rates go through the roof. The economy sputters to a halt and stocks plunge to a panicky and violent bottom. The worst has finally been discounted. But the worst was blacker than even the pessimists suspected.

Which of these three exciting acts is likely to play on Wall Street? My thinking is that the odds favor some variety of act number 3. I consider act number 2 to be a contender, but with the odds somewhat lower for number 2 than number 3. I consider act number 1, the bull scenario; the least likely to materialize.

I believe that we have seen (since late-February) a high-volume rally within a primary bear market. There are two billion shares



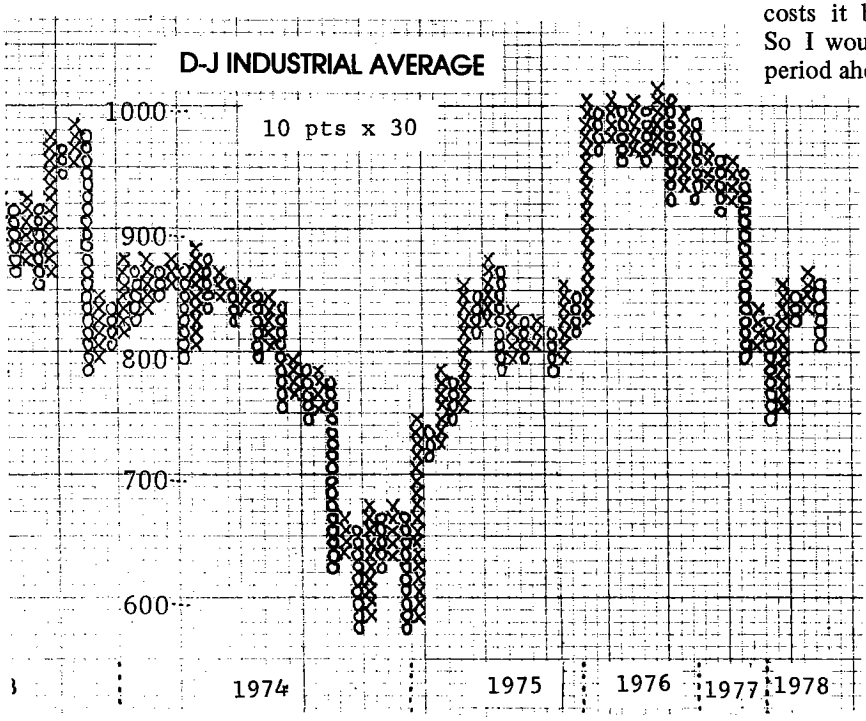
now trapped at higher prices, two billion shares that now need a big rally "to get even again." If I'm correct, if this was a bear market rally, the buyers are not going to get out with their scalps intact.

Within a much wider context I believe we are seeing the beginning, just the beginning, of the inevitable unwinding of the greatest mountain of debt and deficits created since the dawn of man. The problem that all bonds and stocks now face is ILLIQUIDITY. The US economy is now so riddled with debt that more and more monetization of the debt produces less and less. We've come to the point, in fact, where huge infusions of credit produce inflation and inefficiencies rather than progress and productivity. Why is this? It's because there has been no fundamental economic correction in this nation's economy since World War II. The politicians have simply not allowed it. Now the natural forces are beginning to take over.

Interest rates are a function of illiquidity. As illustrated in Letter 732, page 3, each base (low) in interest rates since the 1940's has been at a higher level than the preceding. At present, the discount rate is above 7% for only the second time in Federal Reserve history. Yet the bulk of financing for 1978 lies ahead of us, and loan demand continues at white hot levels. All of which should make the 1978-79 period one of the most interesting and dramatic in the monetary history of America.

In the last two Letters I noted that the Dow rally had halted BELOW the 50% level of the preceding major decline. And I'm talking about the decline from the 1976 peak of 1014.79 to the 1978 low of 742.12. In topping at 866.51 (June 6) the Dow failed to better the halfway level which was 878.45. The inability of the Dow to recoup even half its losses (despite the greatest volume explosion in history) was bearish.

The 50% Principle is also applicable on the downside. The 50% level of the February (742.12) to June (866.51) rally is 804.31. A breaking of the 804.31 level would constitute a second warning under the 50% Principle, and such a violation would imply a forthcoming testing of the February 28 Dow low of 742.12.



This point & figure chart of the Dow helps to tell the story. Each box on the chart represents 10 Dow points, and only rallies or declines of 30 points or more are depicted. The chart provides us with a **concentrated** picture of long-term accumulation and distribution areas. It is clear that the area of 1020 to 920 represents a formidable area of resistance and distribution. It is becoming clear that the 750 to 850 area is also a very powerful area of resistance and distribution.

Note that the entire pattern since 1975 on the Dow is taking the form of a massive head-and-shoulders top. I have drawn the so-called neckline or line of downside resistance. A breaking of this line (at 740) would complete this giant top. If that happens, I would say that the Dow would be in line to test its 1974 low of 577.60.

Of immediate interest is the latest decline in the Dow. The decline has turned this P&F study bearish for the first time since the February low. How did this occur? The bearish signal was given when the last vertical row of O's broke below the preceding row of O's at the 820 level. It would now take a Dow advance to the 880 level to turn this chart bullish again.

I want to mention one interesting item. On the week ending June 30 my 13-week moving average of the Dow was 824. This put it 5 points above the 50-week MA. Thus, a major (but contra-primary trend) buy signal was given under this study as mentioned in Letter 732, page 3. However, I always "soft-pedal it" when these signals appear against what I consider the primary trend, and that is what I am going to do now. I believe this signal is a technical whipsaw, a signal which materialized out of the first correction in the 17-month decline of the Dow. I could be wrong. In retrospect, this could be an important signal. And I'm capable of changing my mind if that proves to be the case. But right now, I believe this market is dangerous and that the primary direction is down. And that's the way I'm playing it and writing it in these reports.

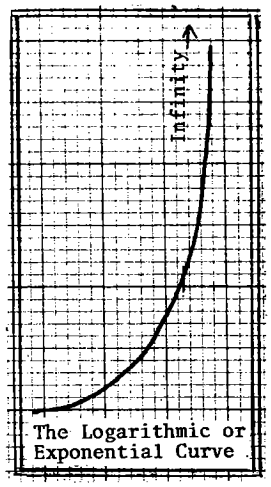
Comment: The large brokerage firms are now charging 11% on margin accounts. With the S&P 500 Average now yielding 5.3%, with the Dow now yielding 5.7%, with the D-J Utilities yielding 8.1%, it becomes a very expensive proposition to carry stocks on margins. But when stocks are going down with high margin costs it becomes more than expensive, it becomes disastrous. So I would expect to see a good deal of margin selling in the period ahead.

MONEY, MONEY: A reader from Phoenix writes, "You have often discussed and pointed out to your readers the power of compound interest. I wonder if the man on the street realizes what a logarithmic curve looks like. If you plot the budget deficit figures shown on page 3, Letter 732, I believe we are into a logarithmic curve." This reader then draws attention to a study of housing costs which he did in 1975, a study which shows housing costs in an accelerating upward curve which extrapolates towards infinity during the period of the early 1980's.

Now we know, of course, that the move into infinity cannot occur. Before that could happen, the new housing market would shut down, since no one could possibly afford a house with housing costs careening towards infinity.

The same thing must happen in the money markets and the debt markets. As the US deficits compound exponentially, the cost of carrying this debt becomes absolutely prohibitive. Interest rates move

erratically but steadily higher (each time from a loftier base) and at some point the entire structure strangles and collapses. That is the path on which we are headed. But I'm not expressing my opinion. It's a fact which anyone who cares to **chart** the path of total US debt can document for himself.



In the last Letter I showed that 75% of the Federal budget is now in the "uncontrollable" class, which means that these expenses are in the segment of the economy in which they are mandated by law. In order to cut these expenses, laws would have to be changed. The so-called uncontrollables represent one area where I predict great changes will occur.

Actually, this is the impetus behind California's now-famous Proposition 13. What happened was that the middle class home owners were taxed at increasingly higher rates, taxed until the whole situation became intolerable. At this point the home owners "revolted," and in effect, elected to simply cut off this source of revenue to the State. The State has now cut back a bit in various areas, but California's $7 billion surplus is helping politicians put off the really painful decision for another year. Once the surplus is gone, the real agony will begin.

Yet California's plight is happy when compared with the Federal Government's predicament. The difference is in the **size** of the Federal budget and the horrendous fact that the Federal Government alone (forgetting the states and cities) now accounts for 32% of the GNP. As the Federal Government breaks from a jog into a gallop in its effort to continue financing the Federal debt, it will come into the money markets for larger and larger amounts. Thus, the Treasury's latest dip into the markets presented us with 15 year-maturity bonds yielding 8.7%, the highest rates ever seen for Treasury bonds.

But all this is nothing compared with what must occur if the current path is followed. Therefore, I see only two possibilities over the period ahead. (1) The US continues to monetize the debt, continues to borrow in the bond market, continues to run up deficits. This results in a steadily weakening dollar and higher interest rates. Ultimately, the rising interest rates choke off the economy and slump takes over. (2) The US seriously cuts back on spending, the dollar firms, but the spending cutbacks exert a deflationary effect. The country slides into depression, but a period of rebuilding of the economic structure begins. (As a matter of interest, I believe the possibility of number 2 occurring is slim, since I have never yet seen a politician or a Government agency vote himself or itself out of existence).

Question: All right, Russell, you are saying that we are moving relentlessly towards the point of no return on debt. What does that mean for us as investors or survivors? In other words, what do we do about it?

Answer: I think we must face the *long-term implications* of the debt and interest rate picture. And the long-term implications are bearish. In my opinion we are now moving into a period that will be characterized by an unwinding of the debt. California (a bellwether) is now facing a bit of this unwinding in the form of jobs lost, agencies squeezed, services curtailed. There will be more of this in other states and ultimately on a national scale.

As for us, within this long-term framework of liquidation, I believe we will have to be totally **flexible**, and this means relying more and more on TIMING. A friend called from NYC, and repeated to me the argument that common stocks now represent the last oasis of "great value." I immediately replied, "Value compared with what? The classic area of comparison as far as common stocks are concerned is bonds. Stock yields compared with bond yields suggest that stocks are not great values today. In fact, stock yields of 5% compared with Government bond yields of 8.5% suggest that stocks are expensive!" My friend lapsed into silence.

"But don't despair," I countered. "The fact is that the forces of liquidation (the bear market) have forced us, as survivors, to depend increasingly on timing and speculation. If I'm correct, there will be an excellent buy spot coming up for us in common stocks, and I intend to take advantage of it. At that time, gold may be a sale, bonds will probably be a buy, and we will have to move. In other words, we will have to take advantage of the pauses and respites in the long term bear market, and we are going to have to move surely and fast."

I added, "I think somehow the public unconsciously realizes this, but they have translated the process into a fascination with gambling rather than an interest in informed speculation. The fact is that people realize that they can no longer **save** in the classic American manner (inflation has wrecked their savings plans). People can't save money any longer (taxes), they can't hold stocks for extended periods any more (the market has become too erratic). And with capital gains taxes so high–long term holdings present an unfavorable risk-reward ratio. So what's left? In desperation, the public has turned to the only area remaining to them–gambling.

Question: Russell, are you saying that there will be no long bull markets in the future?

Answer: Most market movements are understood years after they occur–and then only imperfectly so. My own feeling is that a generation from now people will look back and identify 1966 as the peak of a great bull market. They will see all the action from 1966 into probably the early 1980's as a huge bear market. Bear markets exist for the purpose of squeezing the water out of stocks and the economy, water which has bloated the financial world during the preceding bull market.

The long slide in stocks which began in 1966 and ended in the 1974 market bottom succeeded in squeezing a tremendous amount of water out of common stocks and also out of bonds. But little was squeezed out of the economy. As a result, there are more excesses built into the economy now than at any other time in history. In the end, the economy will go through a purging, and debt will be liquidated in the classic way–or we will have to repudiate the national debt. In that case we will probably end up with a new economic and political system.

As for long bull markets, I believe that from here on movements in the markets are going to be very erratic with rallies probably fast and furious and declines dragging and tedious. The brakes for the market during all advances will continue to be money rates, which have surged from a higher base during each phase of money-tightening since World War II. This tightening of inter-

est rates has given rise to the whirling circle shown on the Dow chart in the last Letter. But sooner or later, the process of liquidation must begin–and the debt must unwind. That unwinding is what every President, every Fed Chairman, every politician since Truman, has tried to avoid.

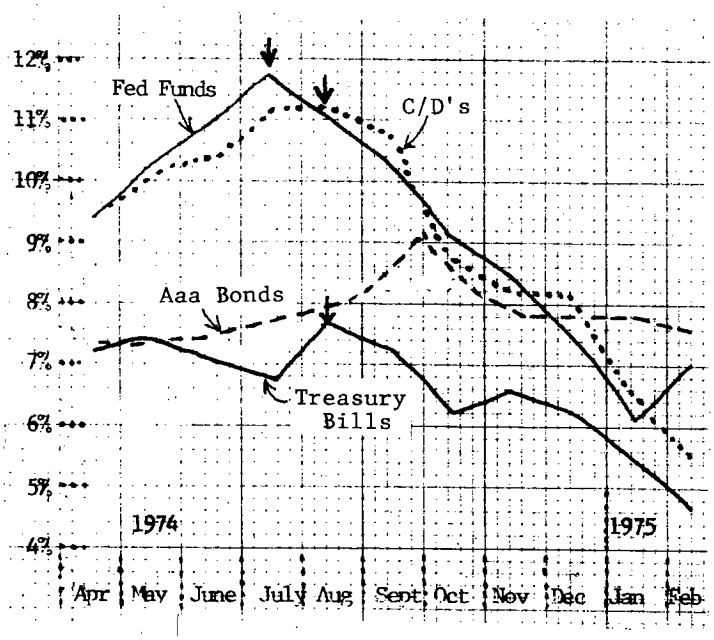
Question: In view of all this, what is your opinion on what is now happening in Washington?

Answer: I believe that President Carter will be the last populist President for many years to come. To my mind, Carter is "out of it." He came to the Presidency with absolutely no inkling of the problems that he would have to face. He assumed the Presidency with no philosophy except to be "fair." Unfortunately, fairness is not going to provide the answers. The answers can only come from a sane response to the *situation*. When a company is bankrupt, fairness won't solve its problems. When a man is hooked on heroin, fairness won't solve his problem. This nation's problems are beyond Carter and beyond simply "being fair." From a political standpoint, the bad news is that we have Mr. Carter as President. The good news is that he has only 2½ more years to go.

INTEREST RATE PEAKS: Something new has been added to the interest rate picture, and it's the entrance of the mortgage bonds being marketed by financial institutions. These bonds are a collection of the bank's (or savings and loan's) mortgages, packaged to be sold to the public. Thus the mortgage and the bond markets are now *linked together* as never before. But the important part of the picture is that there are over $1 trillion in mortgages "out there," and this represents a potentially endless supply of mortgage bonds for the public to absorb.

On top of this, more and more corporations are circumventing the banks by issuing their own commercial paper. Commercial paper is simply a note issued by a corporation which represents a promise to pay at a certain rate of interest. The commercial paper market (which is outside the Fed system) has ballooned enormously into the tens of billions of dollars in recent years.

These new sources of borrowing make the money market more difficult to track and analyze than ever before. Nevertheless, it is critically important for us to try to catch the major turns in interest rates. One reason the interest rate peaks and bottoms



are so important is that they almost always arrive before the peaks and bottoms in the stock market.

I have drawn a chart which shows the progression of interest rate peaks in 1974. All of these peaks occurred prior to the final stock market lows in December. The first item to top was the Fed funds. Fed funds hit a high of 12.92% in July, 1974 (5 months prior to the final December low in the Dow). Certificates of Deposit peaked in July at 12.23, just days after the Fed Funds peaked. In August Treasury Bills topped at a peak of 8.74.

As a point of interest, as fear about the economy increased during mid-1974, the yield spread between the very safe T-bills and the riskier C/D's increased tremendously. By July, 1974 the T-bills yielded 7.75 while C/D's yielded 12.23 for a yield spread of 4.48. But 7 months later, with the stock market up and confidence returning, the yield spread between T-bills and C/D's had narrowed to less than 1%. Thus the yield spread can be of great help in identifying the peak or climax of the yield climb.

Referring to the chart, note that high-grade Aaa-rated bonds peaked in October at an average yield of 9.27%. But lower grade (Baa) bonds (not shown) peaked three months later with yields as high as 19.62 (the yield peak on the Baa bonds actually came one month after the final low on the Dow).

So looking at the chart it is clear that the first signal of a peak in interest rates will probably come from a peak in yields on Fed Funds and C/D's with perhaps a simultaneous peak in T-bills. And a characteristic we will be watching for will be a widening spread between C/D and T-bill yields. While the widest yield spread in 1974 was near 5%, the C/D toT-bill yield spread is now less than 1%.

NOTES & QUOTES: (1) The July *Bank Credit Analyst* just arrived, and Editor Tony Boeckh notes that monetary and bank credit conditions have deteriorated even further (which means an increasingly negative background for stocks). Boeckh states that although many people are aware of the squeeze on the banks, few realize that corporate liquidity is at a new secular low. He notes that since 1976 the corporate financial position *"has eroded sharply . . . . in spite of the lag in capital spending so far in this cycle . . . . If ever there should have been a period of financial prosperity for the corporate sector, the last three years should have been it."*

Boeckh observes that corporations have evidenced a steady decline in the rate of real return on their productive assets. Thus, regardless of book value or replacement value, the market appears to be pricing stocks on the basis of ability to earn in relation to their productive assets. The situation is very much like the one a friend described to me yesterday: "I sold my ranch in California," he said. "I sold it for a million and a half dollars. And do you know why I sold it? I couldn't make a nickel on it. To me it wasn't worth a damn, so I took the million and a half and ran." And that's what the stock market has been doing to stocks (especially the big, "backbone-of-the economy" stocks) ever since 1966 or 1968.

When will it all end? When will stocks sell on a reasonable relationship to their replacement values? When inflation ends, when Governments get out of our hair, when red tape and regulations are cut out of the system, when the US free enterprise gains some semblence of freedom again.

(2) The dollar has been sickeningly weak over recent weeks. The trade-weighted dollar (dollar measured against 14 other currencies) slumped to a new low last week. Meanwhile the Yen and the Swiss franc surge to new highs. All this militates in favor of higher (protective) interest rates in the US.

(3) Commodities (most of them) have been whipsawing traders to death over recent months. Everyone has been losing money in them (now that trading them has become so popular). Some of the experts I follow predict a big commodity bull market coming up in the next few months; they believe commodities are shaking out and basing for the coming bull market now. My opinion: if commodities don't start up strongly between now and the end of the year, watch it. I would take such action as a forerunner of deflation.

(4) Morality in the US is hitting new lows. Witness firemen on strike in Memphis actually lighting fires to pressure for higher wages. It makes me wonder what would happen if this nation went into a broad, deep slump or depression. The violence and civil disorder would be unbelievable, in my opinion.

(5) Real estate prices in Southern California are still sky high. People are now buying because they "are certain inflation is going to send prices even higher." Thus, they are taking on mortgages at wildly high interest rates on the theory that all housing is an investment. We'll see. Turnover of housing is now slowing in San Diego and many co-ops are now up for sale (at unbelievable prices).

(6) The recent historic Sotheby auction of the fabulous Von Hirsch art collection was expected (by Sotheby) to bring in about $14 million. It brought in over $30 million. I take this to mean that international investors still want to hedge against paper money. Personally, I thought many of the prices bordered on insanity.

(7) In the recent Fed discount rate rise to 7¼%, Fed Chairman Miller voted against the rise but was outvoted by the Board. I think Miller is partly beholden to Carter, partly worried about the economy. But the Fed is just following the money markets, and the money markets are bigger than Miller, the Fed and the whole Congress combined. The money markets see deficits and pressure ahead. For instance, the new 15-year Treasury bonds came out to yield 8.61%, a record. These bonds are already under par and priced to yield 8.7%.

(8) With the dollar at new lows for years, almost nobody is saying a thing about it. It's not news any more. When new highs (or new lows) in a widely watched item cease to attract headlines–be careful! The move (in this case the move down in the dollar) is apt to be a big one).

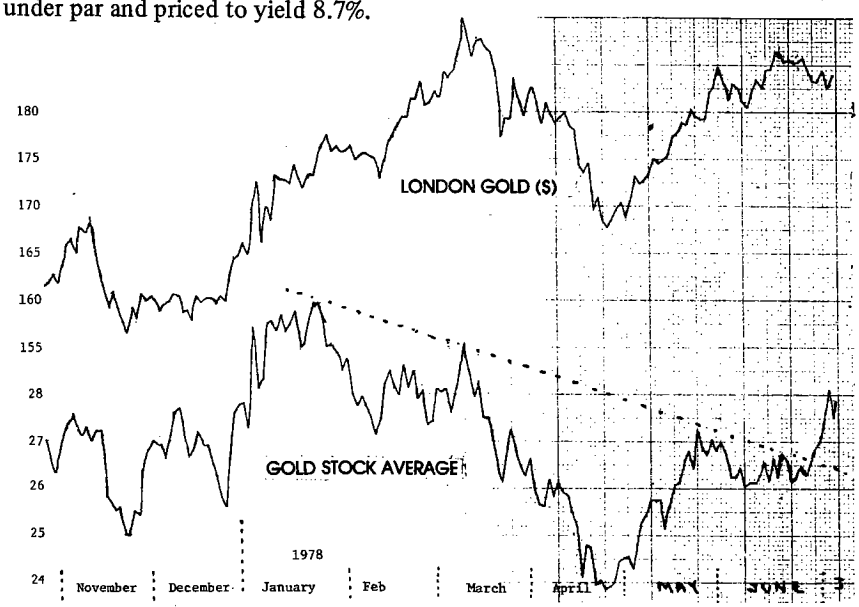
(9) In a recent paper, Dr. Arthur Laffer (USC) states that the total liabilities of the Social Security system are now $4 trillion or around $20,000 for every man, woman and child in the US. If allowed to continue, says Lasser, the system will bankrupt the US economy and destroy the incentives to work and save. People tell me that deflation "can not happen" in the US. I say it can. It will happen when the expenses of the US Government are cut. And they will be cut. They'll be cut or in due time the whole system of compounded debt will go under water.

(10) Figures released yesterday show consumer installment financing jumped $3.9 billion in June, the second biggest leap in history. It seems obvious that consumers are trying to jump the gun in order to beat inflation. I view this as obvious because (a) they are extending themselves financially and thus borrowing from tomorrow's sales, and (b) it shows the widespread almost consensus view that inflation will be worse tomorrow. Can the public be that correct?

GOLD: I said this in a recent Letter and I want to repeat it: I believe gold has already **discounted** all the inflation we're going to see during the period ahead. If gold is to go higher, the next advance is going to be based on fear. Fear of what? Fear for the dollar, fear of paper money, fear of a banking collapse, you name it, but it's going to be fear.

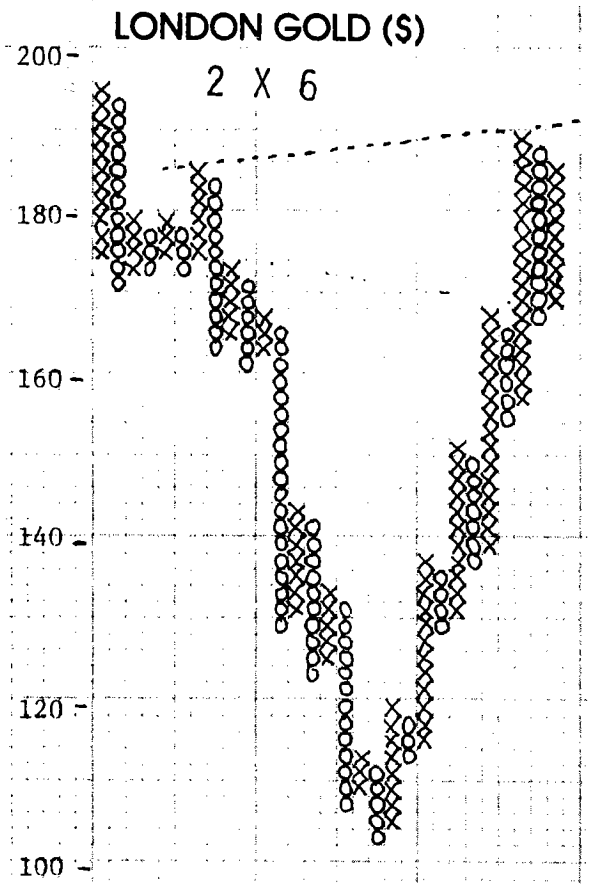
Gold is having a devil of a time "getting its act together." In Letter 732 I included a daily chart of bullion and my gold average (the gold average is simply ASA and Campbell Red Lake added together daily and divided by two). I have noted that the bullion and the gold average tend to *confirm each other*, but the non-confirmations are always interesting and often predictive.

Note on the chart below that the gold stock average (SA) broke to a new low in April, a low unconfirmed by bullion. This led to an upside reversal. Both indicators touched highs in mid-May. Since then bullion and the SA have not been able to get in gear. Last week, a reversal of form occurred, and for a change the SA broke upside to its highest level since early March, but the bullion refused to follow. Nevertheless, despite recent non-confirmations, both bullion and the stock average have refused to drop to new minor lows together, and this is a bullish sign.



It would now take a move in bullion to the 187 level to signal a joint (bullish) breakout on the part of the **two** indices. We'll just have to see whether such action occurs. But again I want to draw attention to the better action of the stocks. For the first time since January the stocks have been exhibiting strength. On this basis, I would say that any move in bullion above 187 would be very bullish for the whole golden picture.

I am including (on page 6) my 2X6 point & figure chart of gold. It clearly shows the pattern I have been pointing to over and over again. That pattern is a massive head-and-shoulders bottom. The horizontal dashed line depicts the upside resistance for bullion. A breakout would occur at a price of 192. My belief is that 192 will be seen in due time. And when 192 is finally touched, we should all be treated to an upside gold move of dramatic proportions.

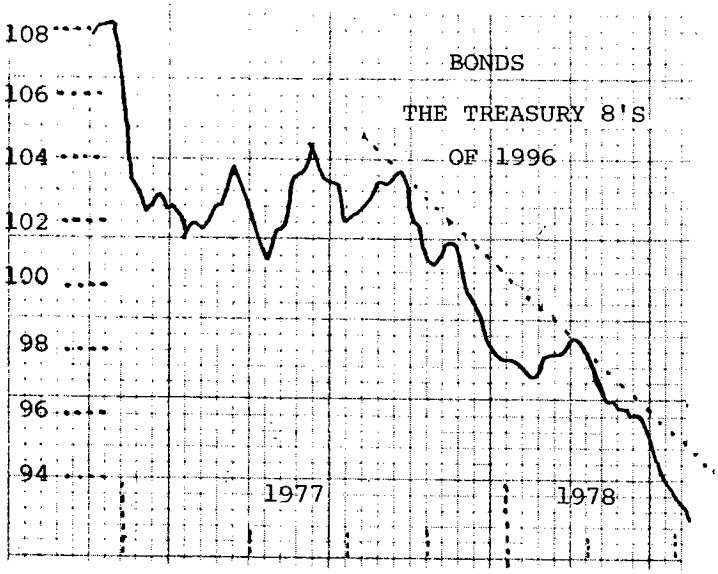


Where does all this leave us? I continue to think the gold action is good. Gold has been waffling and whipping about of late. And I would guess that it scared most of the future contracts (over the past few weeks) over to the sidelines. Bullish sentiment toward gold has receded to about 67% of the services followed. Many gold traders must be exasperated by now. But this is all to the good. Because gold seems to resent the in-and-out traders, and it seems to favor the long swing players. At any rate, I'm holding for the longer pull, and I'm treating my bullion as an "insurance policy" rather than a crap shoot. I suggest that my readers do the same.

LATE NOTES: As of July 6 (Dow was 807.17) the A-D ratio had declined on 15 of the last 21 preceding trading sessions! Although my market statistics did not show a full over-sold situation on that day, it was clear that the preponderance of downside to upside days was very lop-sided. This called for a rally, and that is what we've been seeing. Of interest to me is the breadth-price relationship on the rally. Whereas the A-D ratio (indicative of the majority of NYSE issues) was stronger than the Dow during the February-June advance, the A-D is now acting weaker. Technically, this is a negative.

Furthermore, my Primary Trend Index (PTI) has formed a head-and-shoulders top, and I do not think this index will see new highs regardless of any rally in the Dow. That too is a negative.

On Friday, July 7, the bellwether (and typical) Treasury bond, the 8 of 1996, dropped to an historic low of 93.2 (93 2/32nd's). At this price the bond yields 8.7% on a current yield basis (plus 7 extra points to par if held to maturity. Remember, you also pay no state tax on the Treasuries. At 9%, money doubles in



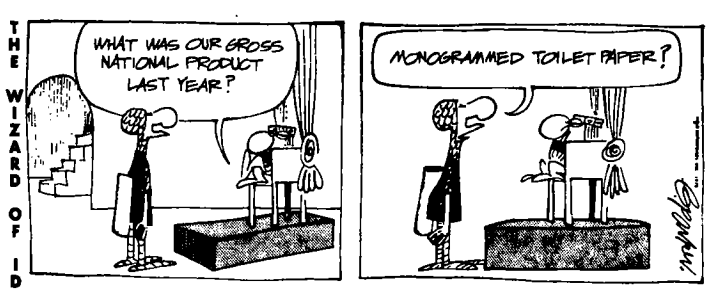
approximately 8 years, and brothers (and sisters), I want to tell you that constitutes tough competition for common stocks!

I dwell on this because interest rates are so critical here. The 8's of 1996 have been declining for a year and a half. You can draw a trendline on the bonds that contains all the downside action since mid-1977. The longer this trendline extends, the lower the price of the bond and the bigger bargain this bond, and all Treasury bonds, become.

One of these weeks or months the bonds are going to rally and break above the trendline. The 8's of 1996 would have to push a bit above 94 to better the trendline at this time. The point I'm getting at is this: I don't know when the Treasuries are going to turn around, next week, next month, or next year. But when they break above the downward trendline, I'm buying them.

The question may be asked, "If the 8's break above the trendline, couldn't that just be a rally in a continuing bear market in bonds?" And the answer is "Yes, but I'll buy the rally, because even if the rally doesn't turn out to be the primary bull turn, it should be a profitable rally, and I want to be in it. I advise my subscribers to do the same. Remember, these bonds will double your money over the next 8 years, and I'm not at all convinced that the stock market will do the same (which is another way of saying that bonds, not stocks, are becoming the bargain area of the investment world (note: I use the 8's of 1996 merely as an example, but any of the long-term Treasury bonds listed in your paper will serve the same purpose).

FINALE: They say that a play on words is the lowest form of humor. So I'm a low-brow, but I thought this cartoon (with obvious insidious economic implications) was funny.



Stop the presses! Baby Ryan (now 4 months and 18 lbs.) just cut his first two teeth.

NEXT MAILING: July 26th